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Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

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Mexico: Austerity and Domestic Stability

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Summary

President Miguel de la Madrid made a fast start in addressing Mexico's financial and economic crisis, but growing problems threaten the new IMF-sponsored economic stabilization package. Austerity efforts and record inflation are beginning to lower standards of living, and de la Madrid is finding it harder to hold the full support of labor and the middle class. Labor leaders, for example, are demanding that the program be eased with an emergency wage hike of nearly 50 percent. Meanwhile, we believe that the chances are growing for sporadic wildcat strikes, consumer demonstrations, dissension within the ruling party, and perhaps large-scale antigovernment protests by labor, students, and opposition groups. 25X1

We expect that de la Madrid will soon have to choose between policies that will promote stability and those that will maintain austerity. Faced with this trade-off, he will likely choose the social and economic programs that have traditionally ensured domestic peace. Aware that the austerity situation is potentially explosive, he has already reversed commitments to cut food and public transport subsidies and launched a huge new public works program. 25X1

External factors are also throwing de la Madrid's austerity efforts off course. The weak world oil market has slashed export revenues. A

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$5 to $10 per barrel drop in world oil prices will severely limit Mexico's policy options. Mexico has no choice but to lower oil prices to defend its market share, and with each $1 change in world prices, Pemex's annual receipts drop by $550 million. [redacted] 25X1

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[redacted] *soaring domestic inflation, backsliding from austerity, and weak world demand for exports will cause Mexico to miss quarterly IMF targets for the budget deficit and for public sector credit.* [redacted] 25X1

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Missing these targets, in turn, will cause the IMF and international bankers to withhold funds as Mexico renegotiates the terms of its stabilization program. If the international financial community judges de la Madrid's economic policies to be positive and his problems beyond his control--and we believe the chances are better than even that they will--we see only a temporary interruption in loan disbursements. Even so, such a disruption will add to the problems of restoring public confidence and reversing capital flight, and will undermine business recovery. If world oil prices fall $5 a barrel and only temporary interruptions in planned capital inflows occur, GDP would fall 3 percent this year. A $10 a barrel drop in world oil prices would make GDP decline 5 percent. The gains brought about by lower world interest rates and higher tourism earnings will be insufficient to offset the negative factors. [redacted]

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On the other hand, international bankers might judge de la Madrid's policies unfavorably--if, for example, Mexico misses early IMF targets by wide margins and fails to obtain more lenient terms. In this situation, with the loss of international financial support and a $5 per barrel fall in world oil prices, imports would plummet, and economic activity would fall by 8 percent. A steeper fall in world oil prices would cut economic activity an additional 2 percentage points. [redacted] 25X1

The severity, depth, and duration of the economic crisis are testing the durability of Mexico's political system, which has never before been buffeted by the pressures we see developing. The government's traditional means of controlling dissidents--co-option, incorporation, and selective use of force--may not suffice and it may need to turn to repression. So far, this specter has not emerged. Most labor and businessmen are behind the concept of de la Madrid's austerity efforts; the rural sector remains quiet; and opposition parties reluctant to directly attack government policies. [redacted] 25X1

Austerity, however, is hitting consumers hard and the government may soon face unprecedented pressure. We believe the government would have little difficulty rationalizing the use of force as needed. De la Madrid appears ready to deal quickly and forcefully with potential trouble; he has already warned those planning protests that established procedures must be followed. [redacted] 25X1

We see little indication, however, that Mexicans are preparing to abandon the system. The country's institutions are strong, its leaders competent and willing to adjust, and as yet there is no strong alternative leader or program to attract a cohesive opposition. National pride in Mexico's long history of stability, the efficacy of the government, and the prospect of eventual economic recovery will further strengthen the country's ability to withstand shocks. Moreover, a breakdown in consensus would be a process of slow erosion which, in a sophisticated, open society such as Mexico, would not escape notice.

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The Mexican military has turned its full attention to internal security after focusing for several years on modernization to enhance the international prestige. Military leaders are strongly backing the administration's austerity moves and are preparing to counter eruptions of violence. Because Mexico's military modernization program was prompted primarily by a desire for international prestige, it did little to improve internal security. However, as long as incidents remain scattered, we expect the Mexican military's reputation for strong action plus its ability to distribute limited resources to trouble spots will serve to retain control. In the less likely event that intimidation does not work, manpower shortages, planning deficiencies, and serious logistical constraints would in the longer term leave the armed forces unprepared to handle multiple simultaneous threats throughout the country.

To maintain Washington's financial backing, de la Madrid will seek to keep Mexican-US relations on an even keel, but we think some grating episodes are inevitable. Illegal migration is surging with no letup in sight. Sharp devaluations have scaled back bilateral trade and as a result bankruptcies are growing along the US border. A Mexican interest moratorium or a more general debt repudiation would sharply lower US bank profits, threaten insolvency in some instances and, in the worst case, probably require large scale Federal Reserve assistance to others because of runs on savings and checking accounts by worried depositors. Accordingly we believe Mexico City expects the US government to lobby the IMF for more lenient terms for the stabilization programs, and for access to additional funds. Mexico City will also expect US officials to back its efforts to secure additional funds from commercial and official sources and to reschedule its debt.

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De La Madrid's Early Moves

President de la Madrid moved quickly to impose a program of economic initiatives that reassured the international financial community and gained Mexico a $4 billion IMF loan, new financial

commitments from world bankers and foreign governments, and set the stage for a massive Mexican debt rescheduling. His 1983 budget mandated a 20 percent real cut in non-debt related spending and a 30 percent real increase in revenues in order to reduce the public sector deficit from 17 percent of GDP in 1982 to 8.5 percent in 1983. Mexico removed price controls on all but 300 basic--largely public sector supplied--commodities, eased foreign exchange controls and raised domestic interest rates. In mid-December the peso was devalued for the third time in 1982, establishing a controlled rate at 95 pesos to the dollar and a free market rate that opened at 148 pesos to the dollar. The controlled rate is now being adjusted 13 centavos a day to eventually unify it with the free market rate. 25X1

Concurrent with his early economic moves, de la Madrid put forward several political initiatives and worked to establish a "clean" presidential image. Legislation pushed through Congress in December established a cabinet-level Comptroller General to monitor government spending procedures, strictly limited outside income for officials, and better defined illegal activities such as influence peddling. To draw top intelligence and security personnel into the decisionmaking process in the critical months ahead, the President has also established a Superior Council of National Security with representatives of the Ministries of Defense Navy, Interior, Foreign Relations, and Justice. 25X1

De la Madrid's early maneuverings have been adroit and the tense atmosphere of the transition period has dissipated. A massive jobs program reflects de la Madrid's intention to balance economic necessity with what is politically possible, while gestures toward the military suggest his willingness to use force as needed. Most Mexicans give high marks to the president's low key, down-to-business style, his vigorous attack on inefficient policies, and his measures to curb official abuses of power.

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Crucial Labor Support

De la Madrid's greatest initial success, in our view, was his ability to gain union leaders' support for only moderate wage hikes. At the end of December, the government announced a labor, government, and management solidarity pact designed to keep wages in line, maintain subsidies, and control food prices (while assuring supplies). As a part of this deal, labor accepted an increase in minimum wages of 25 percent, with an additional 12.5 percent promised this summer. 25X1

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In exchange for labor's acceptance of moderate wage hikes, de la Madrid lowered some taxes and scrapped plans to raise public transport fares. In addition, the National Minimum Wage Commission--composed of government, private sector, and labor representatives--was allowed to meet more than once a year to discuss wage rates. We believe labor's willingness to accept pay well below projected rates of inflation reflected de la Madrid's success in convincing Mexicans of the need for at least some belt-tightening. At the same time, the pact helped persuade international lenders and business leaders that de la Madrid was committed to austerity and that he could control major interest groups.

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The Financial Package

Mexico also made progress on a series of massive financial deals totaling more than $30 billion over the next three years. These arrangements involve the IMF, more than 1400 foreign commercial banks, and numerous foreign governments.* Successful completion of these deals is needed if Mexico is to avoid default on 1983 interest payments of $11 billion due on its $84.3 billion foreign debt. Although the IMF provides only a fraction of the funds, its continuing support is essential to keep other financing. In early January, Mexico drew its first quarterly installment of $330 million from the three-year, $4 billion IMF package.

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More important right now is $7 billion in new credits for 1983 arranged with foreign governments and commercial banks. In recent months, foreign governments and international organizations committed $2 billion for 1983--a sizable increase in their support--and at the end of February, commercial banks announced full subscription of the $5 billion. Payments from the private credit are to be made in four installments, contingent on the quarterly IMF tranches.

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Less progress has been made on rescheduling Mexico's debt. In late December, Mexico City formally requested that commercial banks reschedule over $20 billion in arrearages and principal oligations due on $70.3 billion in public sector debt through 1984. Nevertheless, difficulties getting the $5 billion private credit have prevented Mexico's foreign bank advisory group from turning their attention to this even more complex issue. As a result, we expect the moratorium on principal payments to be extended beyond the end of March expiration date. 25X1

**For more details, see table 1, Mexico: The Public-sector Financial Package.*

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No such unified effort has been made to resolve payments problems on $14 billion in privately held debt. Since August, private firms have built up arrears of more than $2 billion, nearly equally divided between interest and principal obligations. To partially meet past due interest obligations, the private sector is depositing pesos with the Bank of Mexico at the controlled exchange rate. The government paid 10 percent of the outstanding balances on 10 February, and has promised to make future payments as foreign exchange becomes available. [redacted] 25X1

Paying the Piper

We see the steep decline in economic activity that began in late 1982 continuing in the first quarter. The soft world oil market and Mexico's unwillingness to lower prices slashed oil exports between November and February. Mexico's merchandise imports are running 50 percent below last year, and businessmen report capacity utilization in most industries down between 50 and 70 percent compared with 90 percent during the previous two years. Because of these trends, we largely agree with the forecast by Data Resources Incorporated (DRI) that economic activity will fall at a 6 percent rate for the first quarter of 1983. [redacted]

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Weak International Demand

External economic factors are disrupting de la Madrid's efforts. Weak world commodity demand has put a drag on nonoil sales, and the soft oil market and Mexico's slow response to market signals pared oil export earnings. Mexico's reluctance to match the reduction in spot oil prices could cut February oil earnings $500 million, even though Pemex announced late in the month it would adopt competitive prices once world trends become clear. [redacted]

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Despite the devaluations that have undervalued the peso for trade purposes, nonoil export revenues are flat. Mexican business leaders report that their efforts to develop new exports have been straitjacketed by confusing laws, cumbersome bureaucratic procedures, and rapid changes in trade policies. Exporters indicate that they are having trouble maintaining production because Mexico City is using most export earnings to meet immediate interest obligations, rather than allowing access to the controlled exchange rate for imports of raw materials and intermediate goods. To import essential goods, many exporters

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must resort to the free market where foreign exchange costs 50 percent more than the rate used to convert export earnings. To boost nonoil exports substantially would require a major reorganization of Mexican industry, which for years has concentrated on the local market because of import controls and an overvalued peso. On the other hand, as returning tourists are beginning to publicize travel bargains, tourism and border trade have increased, though not enough to offset export losses. 25X1

On the plus side, lower interest rates in international credit markets have offset some of the lost oil revenues. By February, the London Inter-Bank Offer Rate (LIBOR) had fallen to around 9.5 percent, about 3 percentage points below the average 1982 level. Because the majority of Mexican debt interest is based on the floating LIBOR rate, the effective rate Mexico pays on debt is currently down nearly 2 percentage points even though Mexico's deteriorating credit rating pushed interest spreads 1.5 percentage points above last year for new loans and renegotiated debt. These lower rates allowed Mexico to save almost $150 million per month in January and February. 25X1

Economic Performance in the First Quarter

Shortages of foreign exchange and domestic credit will intensify the private sector slowdown at least until debt arrears are reduced. Because they must rely on the free foreign exchange market for essential imports, despite government guarantees of subsidized exchange for those purchases, business leaders report drastically reduced inventories of spare parts and raw materials. Industrialists interviewed by US officials in Guadalajara say that productivity is falling, and they are cannibalizing equipment, rebuilding rather than replacing, and reverting to older and inferior parts or machines. 25X1

Inflation in January-March 1983 will reach record levels. The soaring peso cost of imports and decontrol of prices on many consumer goods will continue to be the largest factors in the price increases. Pressures in January, when official figures report inflation rose 11 percent, were intense because of the effects of the boost in the value-added tax and a 15 percent adjustment in government controlled prices. Even though we believe the government figures understate inflation, as price decontrol and devaluation work their way through the system, we expect inflation in February and March to stay in the range of 10 percent a month; in that event, inflation during the January-March quarter would run at more than a 200 percent annualized rate. 25X1

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Accumulating Social Pressures

Continuing economic deterioration and record inflation could generate a prolonged crisis that would put Mexican institutions and every segment of the population under stress unprecedented in several generations. Pressures on de la Madrid to weaken the austerity program will mount as important interest groups begin to feel its impact. 25X1

-- Inability to stem inflation is causing the solidarity pact between labor, government, and management to fray. Labor leaders, claiming that January prices rose at three times the rate the official figures indicate, are demanding a meeting of the National Minimum Wage Commission to grant an emergency wage hike of nearly 50 percent. They also are calling for continued price controls on basic foods. 25X1

-- Even if inflation ebbs somewhat as a result of projected budget cuts that lower demand, persisting triple-digit rates will eat into living standards, hurting wage- and salary-earners and the middle class in general. 25X1

-- Further reductions in food and transport subsidies will especially hurt the lower classes. 25X1

-- Additional devaluations--which policymakers indicate will be an important instrument to force a more export-oriented economy--will undercut middle and upper class consumption as imports become even more expensive. 25X1

-- Job losses will increase labor discontent as the government cuts public spending and falling sales force business to reduce production. 25X1

Mexicans will be more likely to bear the pain if they have confidence that the program will eventually bear fruit. Nevertheless, the chance of sporadic wildcat strikes and antigovernment demonstrations will grow as the sacrifices begin to bite. Union leaders, moreover, may push for new concessions if they sense a restiveness in their constituency. Victories by dissidents in local union elections this year--particularly among influential unions such as the government-affiliated Confederation of Mexican Workers--would send a clear message to union and national leaders that policy changes were in order. 25X1

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Missing IMF Targets

Taking domestic and international uncertainties into consideration, we believe the odds of de la Madrid's further backsliding on austerity are better than even and that, as a result, Mexico will fail to meet some IMF targets this year. The requirement to lower the public sector budget deficit from 17 percent to 8.5 percent of GDP is probably the most likely target to be missed. We believe Mexico City will forego necessary spending cuts to maintain domestic stability while a deteriorating tax base and a weakening of the sales and receipts of government enterprises will preclude any offsetting increase in government revenues. Noncompliance with this goal could remain hidden until yearend, however, because of the slow process of budget reporting. [redacted] 25X1

The monetary targets--lending by the Bank of Mexico to the public and private sectors--are also likely to be missed, but routine reporting of these statistics will make failure easier to detect. Recent monetary policy has been designed to meet the financing needs of the public sector. Domestic credit was channeled away from the private sector to government projects and the money supply was expanded rapidly to make up for a lack of domestic savings. We expect Mexico City to continue some of these policies and to respond to pressures for wage hikes and financing requirements for business transactions with steps that will boost domestic credit. Considering de la Madrid's concern for social welfare and political stability, we believe that he will view as unacceptable the growth in unemployment, the reductions in government services, and the increases in bankruptcies that are necessary to meet the IMF credit targets. [redacted] 25X1

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The Harsh Consequences

Continuing Economic Slide

With the current situation and lower world oil prices, any likely path for economic performance this year entails sharp

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reductions in real output and a steep fall in personal income. Even though we foresee backsliding on austerity and missing IMF performance targets, we believe that the chances are better than even that members of the international financial community will allow for a fair amount of flexibility if they perceive the thrust of de la Madrid's economic policies as positive. The IMF is thus likely to permit Mexico to readjust austerity criteria based on the administration's six-year economic plan now scheduled for publication in May, and we believe international bankers are likely to formally reschedule Mexican debt obligations. Nevertheless, we expect many of Mexico City's creditors to press for higher interest and new collateral on rescheduled debt. Moreover, because of the long rescheduling period, we believe creditors may also press for restrictions on Mexican economic policy initiatives beyond the end of the IMF program. Private sector debt will continue to be more difficult with growing arrearages.

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If this occurs, we see a continuation of periodic interruptions in financial disbursements as Mexico City introduces a variety of policy initiatives to regain the support of the foreign financial community. Even so, the bulk of Mexico's new financing will be swallowed up by the need to stay current on government interest obligations, reduce private sector debt arrears, and rebuild inventories. On the positive side, we believe that world interest rates will stay below the high levels of the last several years and that interest obligations will fall almost $1 billion in 1983 to $11 billion. For the year as a whole, capital inflows will decline for the second straight year, and the volume of imports in 1983 will be lower than in 1982.*

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Under these circumstances, we project that 1983 economic performance will be substantially worse than in 1982. Import shortages will hit construction, manufacturing, and commerce hardest. Domestic budget cuts will, in a similar fashion, slice government and other service activities. Even the minerals sector--which, paced by oil development, has been the engine of dynamic Mexican economic growth for the past eight years--will not avoid the slump because of budget cutbacks and falling world oil prices. Each $1 drop in oil prices costs Mexico $550 million in export earnings. Moreover, we expect a small decline in export volume, reflecting the reduction in world oil trade. For 1983 we project, at best, that with a $5 a barrel drop in world oil prices and only temporary interruptions in financial inflows,

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**See table 3, Mexico: Foreign Financial Gap.*

economic activity will fall 3 percent and that average annual inflation will stay at triple digits. 25X1

A sharper decline in the world oil market with prices falling $10 a barrel would cause further deterioration in Mexico's economy, even with continuing financial support from the IMF and world bankers. Export earnings would fall by $3 billion and the ensuing drop in import capacity would cut economic activity an additional 2 percent. 25X1

Deepening Crisis

On the other hand, if Mexico misses its IMF targets by wide margins and international bankers perceive that de la Madrid's policies are off base, we believe that the risk of losing international financing is significant. If Mexico lost IMF support, international bankers would cut off additional commercial credit. In the resulting financial confusion, the economy would go into a nosedive. Inability to meet scheduled debt payments would cause financial chaos and, we believe, would lead to another surge in capital flight. If new debt rescheduling efforts failed, foreign bankers would begin foreclosing on loans and trying to seize Mexican assets. In this case, as debt arrears mounted, many Mexicans, including intellectuals and some influential members of the leftwing of the ruling party, would call for a moratorium on interest payments. While we judge that, in this case, many Western governments and foreign bankers would seek to avoid further chaos by setting up another short-term debt payment moratorium, the economy would be severely damaged.

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Under these circumstances, international financial problems and a $5 per barrel fall in world oil prices would slash imports to the bone. Without a moratorium on interest obligations, we calculate real imports would fall as much as 40 percent below the depressed 1982 level. We estimate that such an import cut would slash the availability of raw material for industrial production and machinery and equipment for investments. Construction activity would come to a virtual halt, while manufacturing and normal commercial activities would tumble into a steep decline. Economic activity would then fall by 8 percent, according to econometric analysis. If world oil prices fell $10 a barrel, the drop would be 10 percent.* 25X1

*See table 4, *Mexico: Impact of Economic Deterioration, 1983*, and table 5, *Mexico: Impact of Lower Oil Prices*.

[redacted]

Political Fallout from Economic Dislocations

The severity, depth, and duration of the economic crisis are testing the durability of the political system. Mexico's institutions have not been so buffeted in decades by the pressures as we currently see developing. The government's traditional means of controlling dissidents--co-option, incorporation, and selective use of force--may prove insufficient. So far, only isolated strikes, demonstrations, and takeovers of several town halls to protest alleged electoral fraud have occurred and the government is firmly in control. Early compromises with organized labor leaders were worked out and labor and most businessmen hold to the concept of austerity. The rural sector is relatively quiet and opposition parties remain reluctant to directly attack government policies. [redacted]

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The effects of austerity, however, are now hitting consumers hard and the government might soon face unprecedented pressure. At any time perceived inequities in public policy or a loss of confidence over the government's management of a particular issue or problem could translate into internal security problems. We believe government officials would have little difficulty rationalizing the use of force; de la Madrid appears ready to deal quickly and forcefully with potential disorder to provide an object lesson to dissident elements. He has already warned those planning protests that established procedures must be followed. [redacted]

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We see little indication, however, that Mexicans are preparing to abandon the system. The country's institutions are strong, its leaders competent and willing to adjust, and as yet there is no strong alternative leader or program to attract a cohesive opposition. National pride in Mexico's long history of stability, the efficacy of the government, and the prospect of eventual economic recovery will further strengthen the country's ability to withstand shocks. A breakdown in consensus would be a process of slow erosion which, in a sophisticated, open society such as Mexico's, is capable of being monitored. [redacted]

Reactions Of Key Groups

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Organized Labor

Organized labor's loyalty will be key to continued political stability. Although union cadres appear increasingly restive because of record inflation, labor leaders are not yet prepared to abandon the president's program. Even with January's modest

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wage hike, de la Madrid received a warm welcome at a recent labor congress where union patriarch Fidel Velazquez stated that the labor movement was--and always would be--with the president. [redacted]

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[redacted]

Urgent calls for emergency wage increases could spark a showdown if de la Madrid is unable to hammer out a satisfactory compromise. Under these circumstances, even long-established lines of personal communication could fail to prevent strikes aimed at dramatizing the seriousness of labor demands. Initial strikes, we believe, would be centered in non-essential manufacturing to avoid serious damage to the economy. [redacted] 25X1

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A sharp fall in world oil prices and the loss of international financial support would cause widespread plant shutdowns and massive layoffs. Labor might then press for nationalizations of troubled industries; foreign-owned pharmaceutical and auto plants would be candidates for expropriation. Labor--the mainstay of the ruling party--might throw its weight behind radical solutions proposed by the left wing or otherwise threaten massive defection. Workers would be particularly susceptible to calls for unilateral debt repudiation and new controls to shield Mexican business from foreign competition. [redacted] 25X1

The Peasantry

While clashes between landless peasants and property owners may increase as a result of the economic crisis, we believe widespread violence in the countryside is unlikely. The government has recently invested substantial sums in rural development and, although disadvantaged, peasants are still Mexico's least unruly element. De la Madrid's rural jobs program and his promises to resolve longstanding land title disputes should also help ease tensions. [redacted] 25X1

The potential for rural unrest is not far below the surface, however. Workers on commercial farms that produce for export and urban consumption will be hard hit by inflation and any moves to economize by land-owners. They could respond with large-scale land invasions similiar to those in the final days of the Echeverria administration. [redacted]

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Opposition Parties

Growing dissatisfaction with austerity and the government's economic mismanagement would provide opposition parties with an unprecedented opportunity to expand popular support. Federal elections are not scheduled until 1985. Contests in 15 states throughout the year could be significant if the opposition capitalizes consistently on PRI failures. Strong performances by opposition candidates coupled with low voter turnouts would embarrass the ruling party and add weight to demands for meaningful electoral reforms. The center-right National Action Party, the largest opposition group, would probably be the chief
25X1 beneficiary of public backlash, especially if it can build stronger links with labor. The Communist-dominated Unified Socialist Party, plagued with internal discord, poses less of a threat. [redacted] 25X1

Traditionally, opposition parties have avoided violence and, even in the event of a sharp economic downturn most would still press for electoral reforms and positions in the cabinet rather than take up arms. While de la Madrid's plans to promote "federalism" signal a willingness on the part of some PRI officials to allow a more open government, any move toward actually sharing power probably would precipitate a crisis within the PRI. [redacted] 25X6

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The Middle Class and Private Sector

The PRI's "popular sector"--amorphous and dominated by middle-echelon, white-collar workers and teachers--is easily manipulated by the ruling party-government complex. It is concentrated in urban areas and heavily dependent upon government subsidies for transportation, food and fuel. The diverse interests of this group make it organizationally weak and it lacks a leader with stature. As a result, under most

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circumstances the middle class would have difficulty organizing significant protests. [redacted]

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Alienation of the middle class, however, would increase rapidly with a sharp economic downturn. This class has the potential, especially if a dynamic leadership emerges, to mount highly disruptive consumer boycotts, shutdowns of essential services, and teachers' and university students' strikes. Moreover, middle class defections from the ruling party would set a precedent for other dissatisfied groups. [redacted] 25X1

Businessmen have been encouraged by de la Madrid's budget cuts, cabinet appointments, and the abandonment of the previous administration's anti-business rhetoric. While understanding the need for austerity, until businessmen begin to see a chance for renewed profits, they will hold back on new investment and keep money abroad. If the economic slide becomes steeper, businessmen will seek new means to move funds to the US. Moreover, we believe nationalizations to prevent plant shutdowns and preserve workers' jobs would spur an exodus of entrepreneurial talent. [redacted]

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Other Factors

A number of developments could turn the economic crisis into a political one. Differences among ruling party leaders over the proper strategy to achieve economic recovery could lead to the defection of party notables. Labor chief Fidel Velazquez's demise--at 82 years old, a distinct possibility--could throw the labor movement's hierarchy into disarray and deprive the President of crucial union support. A series of serious political blunders by the President, an unwillingness to take quick action to maintain order, or lack of agreement on what to do, could create the impression of a power vacuum and provoke widespread challenges to the ruling party-government system. The President's assassination or death would be destabilizing because there is no vice-president and a successor must be selected by Congress. [redacted]

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Unchecked strikes or anti-government demonstrations could inspire outbreaks of urban and rural terrorism and further undercut the administration's ability to govern. The so-called "belts of misery" surrounding Mexico City are the most likely breeding ground for violent and radical movements. Members of Tierra y Libertad, an organization of slum dwellers in northern Mexico, could also take up arms. Petroleum facilities, particularly refineries and pipelines, would be targets of opportunity for terrorists. The danger of clandestine

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interference by international leftists could increase, particularly in the Guatemalan border region where tensions are already high over the question of guerrilla sanctuaries on Mexican soil. [redacted] 25X1

The Military Equation

The military has turned its full attention to maintaining internal security during the economic crisis. So far, military leaders are strongly backing the administration and are preparing to put down the violence which, we believe, the government expects by mid-1983. [redacted] 25X1

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Controlling Scattered Violence

Because Mexico's military modernization program was prompted primarily by a desire for international prestige, few of the program's gains boosted internal security capability. F-5 jet fighters were purchased to defend oil fields. The latest-model French armored reconnaissance vehicles have 90mm. guns, far too large for crowd control, and not suitable for off-road action against rural insurgents. Pursuit of big-ticket items often resulted in neglecting training, spare parts, and ammunition related to the new hardware. Equipment critical for dealing with localized violence--including riot-protection gear, armored cars with water cannon, and basic trucks to carry troops to staging areas--were ignored. [redacted] 25X1

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On the other hand, as long as incidents remain scattered, we believe the military has enough overall resources to retain control. One-fifth of Mexico's total troops--including all the best-trained and -equipped units--are stationed near the capital. At least two of the five brigade-level units in Mexico City are also capable of sending reinforcements within 12 hours to trouble spots throughout the country. The remaining four fifths of Mexico's armed forces are dispersed, with several battalion-sized units--each roughly 600 troops--in each of 35 military zones. Although most of these units are foot infantry, without attached transport, about one third are newly motorized cavalry regiments with sufficient trucks to move the entire unit. [redacted]

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Problems of Widespread Disorders

In the less likely event that the military does not intimidate protestors and crush opposition early, however, the armed forces will encounter serious problems in regaining control should disorders spread. The military is not prepared to handle a wide variety of simultaneous threats--including urban terrorism, economic sabotage, and rural insurgency--that could develop over time. Each would require tailored tactical planning, training, and equipment. Even with good training and discipline, the relatively small military would be stretched too thinly if violence were widespread.* Units could be tied down by static defense of industrial and oil targets that lack their own

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protective systems. Mexico City might well be reluctant to spare reinforcements for outlying states if unrest threatened the capital. Efforts to call up individual reserves trained under the National Military Service Program for 19-year-olds would be seriously slowed, we believe, by indecision about using such troops to quell unrest, lack of peacetime reserve units, absence of adequate mobilization plans, and traditionally poor record-keeping. [redacted] 25X1

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Implications for the US

We believe Mexico--in view of falling economic activity--will turn increasingly to the US for help in maintaining international financial support as well as for new direct assistance. As a result, we believe de la Madrid will seek to keep Mexican-US relations on an even keel. The temptation to shift the blame for its troubles to foreigners is likely to be irresistible, however, and we expect some grating episodes. Bilateral problems will grow as US interests--particularly along the border--are affected by the Mexican crisis. [redacted] 25X1

Mexico's principal bilateral concern will be to preserve Washington's backing in de la Madrid's efforts to keep international financial community on board. In particular, we believe Mexico City expects the US Government to lobby the IMF for more lenient terms for the stabilization package, and for access to additional funds such as $1 billion from the Fund's compensatory financing facility. Mexico City will also expect US officials to back its efforts to secure additional funds from commercial and official sources and to reschedule its debt. At the same time, we project that Mexico will push for new US

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credits for food purchases and new trade credits to finance other imports. 25X1

The decline in Mexican import capacity will cut US exports to Mexico over the next few years substantially below the record $17.8 billion in 1981 and even the $11.8 billion last year. Additionally, we foresee increasing numbers of Mexicans trying to maintain consumption by illegal work trips to the US. The US Immigration and Naturalization Service reports that border arrests jumped 20 percent during the last five months of 1982, and more than 50 percent in January and early February 1983. 25X1

Moreover, most US businesses operating in Mexico--the majority of the $7 billion US investment--will be in for harder times as a result of continuing currency depreciation and declining consumer spending. Increases in the price of industrial fuels and other intermediate goods could lower profits, particularly if the government fails to hold the line on wage settlements as well. On the other hand, US-owned assembly businesses along the border, which process goods for reexport to the United States, are likely to increase sales as long as the peso remains competitive and wage increases are kept within bounds. 25X1

If Mexico responds to a sharp fall in economic activity with intensely nationalistic economic policies, US-Mexican relations will become even more difficult. Such policies would include stiff trade and foreign exchange controls and increasing state dominance of the economy. An interest moratorium, for example, would reduce US bank profits and cause some to fail. A more general debt repudiation would slash US bank assets. More US banks would be threatened, and the Federal Reserve System would probably be called on to support others experiencing funding problems because of runs on savings and check accounts by worried depositors. Expropriation of US firms could tie up US-Mexican trade because of mandatory US sanctions in such situations. As more nationalistic policies further weighed down the economy, border problems would multiply, illegal crossings would reach unprecedented levels, and the already serious problems in the closely intertwined border economies would be increased by the even larger difficulties of US businesses. 25X1

Prospects for dealing with increasing violence will encourage the government to seek additional foreign equipment--including riot protection gear--as well as training and financial aid for the military and police. Extreme sensitivities over turning to the US and the political ammunition it would give opposition groups would make it difficult, we believe, for the

Mexican government to accept any direct US material assistance, even though hard pressed by domestic events. The government would probably look first to European countries and Israel where it also has defense contacts. 25X1

Meanwhile, Mexico's participation in the Contadora Conference* underscores de la Madrid's intention to maintain a low-key but active role in international affairs. While he has told US officials that he intends to avoid inflammatory public statements, the president has publicly stated he will maintain close ties with Havana and Managua. With this lower profile, the new President will, in our view, endeavor to avoid confrontation with Washington and concentrate on global issues in international forums. We see little likelihood that Mexico would turn to the Soviet bloc. But in an effort to halt the fall in oil prices, Mexico City will tie policy decisions more firmly to OPEC. If de la Madrid sensed that domestic support for his administration's policies were waning, we anticipate that he would turn to the foreign policy arena to focus attention elsewhere.

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A meeting of foreign ministers of Mexico, Venezuela, Colombia, and Panama in February to discuss peace initiatives for Central America.

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Appendix

The IMF Targets

We believe Mexico will miss several IMF targets this year. The requirement to lower the public sector budget deficit to 8.5 percent of GDP from 17 percent is unlikely to be met. As inflation sharply reduces real budget allocations over the course of the year, we believe that strong government ministries will use budget overuns to maintain real levels of spending. The central government will probably accommodate these overruns to prevent the firing of the thousands of public employees it would take to stay within budget limits. Moreover, Mexican job security laws and the political strength of key government ministries such as Interior, Defense, Health, and Education will preclude mass layoffs. 25X1

At the same time, we project that real government income will fall short of budgeted revenue levels. Price controls on basic goods will keep receipts substantially below inflation in many government-owned businesses. Because of weak world oil demand, we expect tax remittances by Pemex to the central government to be at least $1 billion below the $11 billion the budget projects. We calculate that receipts from the higher value-added tax probably will fall 20 percent below the 814 billion pesos ($5.5 billion) of revenue projected by the government because of a fall off in economic activity. 25X1

Mexico City will have difficulty limiting both net credit to the public sector by the Bank of Mexico and the change in net domestic assets of the Bank of Mexico to the 34 percent increase allowed by the IMF program for all of 1983. Between last September and December, net credit to the public sector increased by 31 percent and net domestic assets soared by almost 100 percent. To hold the increase in net domestic credit to the public sector to 9 percent in the first quarter seems particularly difficult in light of triple digit inflation. With a large part of its new foreign credits already committed to interest obligation, Mexico City will have to depend on domestic credit to finance continuing subsidies and its new public work program.

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An example of just one of the government's dilemmas in trying to satisfy the IMF requirements while preserving political support is its corn subsidy policy. Because of poor harvests caused by bad weather and inappropriate pricing policies, Mexico City is importing an unprecedented 5 million tons of corn--

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largely under US government credits. After paying $110 per ton for imported corn, Mexico City resells it to bakers for $40 losing the government $350 million on the transactions. While domestically produced corn is not as highly subsidized, the government still loses $200 million on it. We expect the corn subsidies--and other similar subsidies--to continue and increase as Mexico City keeps the rise in such consumer prices significantly below inflation, to avoid alienating crucial labor support or risking a food riot. 25X1

In our assessment, Mexico City is more likely to meet the other three of its six quantitative IMF targets. The probable successes, in our view, will be the reduction of foreign borrowing, the $2.0 billion increase in net foreign reserves, and the reduction of debt arrears by $600 million. On the other hand, if devaluation begins to lag substantially behind inflation and other economic shocks drive a skittish public into another round of capital flight, even these targets could be missed.

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TABLE 1

Mexico: The Public Sector Financial Package

Source	Amount (billions of US $) New Funds	Amount (billions of US $) Rescheduled Debt Principal	Comment
IMF	4		Three-year package; $1.3 billion available in four tranches in 1983. Funds contingent on meeting quarterly performance targets.
Commercial Bankers	5	20	New funds available in four installments contingent on adherence to IMF stablization program and receipt of IMF tranches. Rescheduling includes principal obligations due between 23 August 1982 and 31 December 1984. Repayment would begin in 1987 and end in 1990.
Foreign Governments	2		Commitments from US, UK, France, Germany, Spain, Canada and Japan. Funds largely trade-related credits to finance exports from the donor country.

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TABLE 2

Mexico: IMF Quarterly Performance Targets

	September 1982	December 1982 (estimate)	Targets and Limits for 1983: January-March	April-June	July-September	October-December
	Billion Mexican pesos					
Net Credits to the public-sector by the Bank of Mexico[a]	1,763	2,310	2,525	2,689	2,791	3,097
Cumulative overall public-sector deficit[b]		1,605	360	690	1,005	1,500
Cumulative change in net domestic assets of the Bank of Mexico	319[ac]	635[ac]	21	44	44	104
	Million US $					
Cumulative net foreign borrowing by the public sector[b]			1,250	2,500	3,750	5,000
Cumulative change in net international reserves of the Bank of Mexico[b]	734[a]	-585[a]		500	1,000	2,000
Cumulative reductions in arrears[b]						600

[a]End of period.
[b]Limit tested at the end of each period.
[c]Amount subject to ceiling is defined as the difference between note issue and net foreign assets.

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Mexico: Foreign Financing Gap

Million US $

	1975	1980	1981 [a]	1982 [b]	1983	
					Continued Economic Slide [c]	Deepening Crisis [d]
Trade balance	−3,119	−1,647	−3,520	7,000	7,800	10,100
Exports, f.o.b.	3,461	16,925	20,880	22,000	22,800	20,100
Oil and gas	460	10,306	14,400	15,500	15,300	12,600
Manufactures	1,763	3,725	3,750	4,000	4,600	4,600
Agriculture	815	1,544	1,530	1,500	1,700	1,700
Minerals	423	1,350	1,200	1,000	1,200	1,200
Imports, f.o.b.	6,580	18,572	24,400	15,000	15,000	10,000
Net services and transfers	−574	−4,950	−9,480	−12,500	−11,000	−10,000
Interest	−1,437	−5,380	−8,217	−11,900	−11,000	−11,000
Current account balance	−3,693	−6,597	−13,000	−5,500	−3,200	100
Debt amortization	1,058	5,984	6,310	7,000	7,500	7,500
Financial gap	−4,751	−12,581	−19,310	−12,500	−10,700	−7,400
Medium- and long-term capital inflows	5,629	12,460	18,014	13,000	12,700 [e]	9,400 [e]
Net short-term capital (errors and omissions)	−740	1,009	2,396	−2,500	NEGL	−2,000
Changes in reserves	138	888	1,100	−2,000	2,000	NEGL
Other financial items						
External debt (at yearend)	17,600	48,800	74,900	84,300	87,000	83,000
Short term	5,200	16,900	21,900	24,000	23,000	21,000
Debt service ratio *(percent)*	35.0	45.4	47.5	57.7	54.9	56.5

[a] Estimated.
[b] Projected.
[c] Assumes the average price of world oil falls $5 per barrel this year and that Mexico renegotiates IMF support.
[d] Assumes Mexico loses IMF and international banking support and that the average world oil price falls $10 per barrel this year.
[e] Includes 7 billion in world debt relief on medium- and long-term debt principal due.

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TABLE 4

Mexico: Impact of Economic Deterioration, 1983

	From 1982 Levels	
	Continued Economic Slide[a]	Deeper Crisis[b]
Change in GDP (percent)	-3	-10
Unemployment expansion	1,300,000	2,000,000
Inflation (percent)	100	300
Change in real merchandise imports (percent)	-5	-40
Decline in supplies of locally available goods and services (GDP plus exports minus imports) (percent)	-4	-13
Change in investment (percent)	-15	-35
Change in per capita consumption (percent)	-5	-12
Current account balance (billion US $)	-3.2	0.1
Free market exchange rate, pesos per US dollar (yearend)	200 to 250	350 to 400

[a] Assumes Mexico renegotiates IMF and international banker support, and the average world oil price for 1983 falls $5 per barrel.

[b] Assumes Mexico loses IMF support and that foreign bankers, having lost confidence in Mexican economic policies cancel credit lines, and work to reduce bank exposure; and that the average world oil price for 1983 falls $10 per barrel.

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TABLE 5

Mexico: Impact of Lower Oil Prices, 1983

	Changes in GDP (percent)	Inflation (percent)	Current Account Balance (billion US$)
Renegotiate IMF Package[a]			
Decline of $5 per barrel in world oil price[b]	-3.0	100	-3.2
Decline of $10 per barrel in world oil price[c]	-5.0	150	-3.2
Losses IMF Package[d]			
Decline of $5 per barrel in world oil price[b]	-8.0	250	2.9
Decline of $10 per barrel in world oil price[c]	-10.0	300	0.1

[a] Assumes Mexico misses IMF targets but renegotiates IMF and international banking support.
[b] Such a fall would cut Mexico's average oil price to $27 per barrel.
[c] Such a fall would cut Mexico's average oil price to $22 per barrel.
[d] Assumes that the IMF and foreign bankers, having lost confidence in Mexican economic policies, cancel credit lines and work to reduce bank exposures.

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Mexico: Asuterity and Domestic Stability

Original - Requestor
1 - Executive Director, 7E12
1 - SA/DCI/IA, 7E12
1 - C/DDI/PES, 7F24
2 - ALA/PS, 3F38
4 - OCPAS/IMC/CB, 7G07
1 - Division File
5 - Branch File

DDI/ALA/MCD/MX/ (9 March 1983)

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